VZCZCXRO3376
PP RUEHGA RUEHHA RUEHMT RUEHQU RUEHVC
DE RUEHOT #1502/01 3362157
ZNR UUUUU ZZH
P 012157Z DEC 08
FM AMEMBASSY OTTAWA
TO RUEHC/SECSTATE WASHDC PRIORITY 8786
INFO RHEHAAA/WHITE HOUSE WASHDC
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC
RUCNCAN/ALL CANADIAN POSTS COLLECTIVE
RUEHME/AMEMBASSY MEXICO 1898
RUEHRL/AMEMBASSY BERLIN 1140
RUEHFR/AMEMBASSY PARIS 1051
RUEHKO/AMEMBASSY TOKYO 3394
RUEHRO/AMEMBASSY ROME 1393
RUEHLO/AMEMBASSY LONDON 0991
RUEHBS/USEU BRUSSELS 0657

UNCLAS SECTION 01 OF 03 OTTAWA 001502

WHITE HOUSE FOR COUNCIL OF ECONOMIC ADVISORS

STATE FOR WHA, EEB

STATE PASS USTR

COMMERCE FOR ITA/MAC

TREASURY FOR IA/NEPHEW

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN EINV EIND CA
SUBJECT: Harper Government Gives Snapshot of Canada's Economic Health

Refs: (A) Ottawa 1495 (B) Ottawa 1395 (C) Ottawa 1372

Sensitive But Unclassified. Protect accordingly. Not for internet distribution.

¶1. (SBU) Summary: The Conservative government's November 27 Economic and Fiscal Statement stated that Canada is well positioned to weather the uncertainty and risks arising from the global financial crisis. Finance Minister Flaherty said the health of Canadian banks and the financial positions of households, corporations, and government would mitigate the worst impacts of the international downturn. The government expected the Canadian economy to grow 0.6 percent in 2008 and 0.3 percent in 2009, and it planned to run balanced budgets through FY2012-13 - but would not rule out future deficits. Flaherty indicated that the government would likely wait until the New Year before unveiling a possible fiscal stimulus package as recommended at the G20 Summit in Washington last November. Senior Bank of Canada officials privately stated that monetary policy remains effective in Canada. As a result, the Harper government may look to the Bank to stimulate the economy - instead of using fiscal policy - in the coming months. End summary.

Good Fiscal Position May Make Economic Challenges Less Daunting

¶2. (U) In a November 27 message that triggered a contentious political row over political party funding (ref a), the Conservative government's Economic and Fiscal Statement said Canada is well positioned to weather the uncertainty and risks arising from the global financial crisis. (The Economic and Fiscal Statement is typically released in November and provides an update of Canada's economic and fiscal situation ahead of the federal budget, which is typically due in late February or early March. The government has since said the budget would be tabled by January 27, the day after the House is scheduled to return from its year-end recess.) Delivering the Statement in the House of Commons, Finance Minister Jim Flaherty said that the sound footing of Canadian financial institutions (refs b, c) and the relatively strong financial

positions of households, corporations, and government should mitigate the negative impacts of the international economic downturn.

¶3. (SBU) Flaherty stated that private sector economic forecasters expect a "technical recession" in Canada with negative growth in the fourth quarter of 2008 and the first quarter of 2009, despite full-year real GDP growth of 0.6 per cent in 2008 and anticipated growth of 0.3 per cent for 2009. (For its part, the Bank of Canada sees 0.6 percent GDP growth in both calendar 2008 and 2009 due to tighter credit flows, falling external demand - primarily from the United States - and a sharp fall in commodity prices.)

¶4. (SBU) The government's Statement said Canada enjoyed a strong fiscal position when the global financial crisis started, with a budget surplus of C$9.6 billion in FY2007-08 - the best of any G7 country. (Note: Canada's fiscal year runs April 1 to March 31.) The Statement was clear, however, that the surplus would shrink next
QThe Statement was clear, however, that the surplus would shrink next
year. Canada had only a C$804 million budget surplus from April to September 2008, compared to C$6.63 billion for the same period in
¶2007. While the government said it expects to run balanced budgets and even small surpluses through FY 2012-13, global economic uncertainty made it impossible to rule out future deficits. Flaherty, however, promised no "structural deficits." (Federal deficits are a highly sensitive political issue in Canada; in the early 1990s Canada faced an environment of rising debt and deficits and increasing uncertainty about its ability to continue to borrow money from domestic and international institutional investors, and the cost of this source of funds. Subsequently, from roughly 1993 to 1998, the Liberal government of Prime Minister Jean Chretien, with Finance Minister Paul Martin leading the way, erased the

deficit by slashing federal spending. Since that time all Canadian political parties have subscribed to the shibboleth of "no budget deficits.") For their part, opposition political parties said the government's numbers were not credible and that the government was probably already in deficit.

¶5. (SBU) The government's Statement said the sharp decline in world commodity prices in 2008 - primarily for energy and forestry products - will reduce the level of Canada's nominal GDP in 2009 and 2010 compared to earlier estimates. (The government uses nominal GDP as the broadest indicator of Canada's tax base. The Bank of Canada has privately noted that as Canada's nominal GDP growth slows, government spending may come under further pressure.) The Statement also said the sharp appreciation of the Canadian dollar in 2007 and the 2008 U.S. economic slowdown hurt export-intensive sectors, particularly manufacturers and forestry-related products. The government noted that some 75 percent of Canadian manufacturing production is located in central Canada (Ontario and Quebec) and that more than 80 percent of central Canada's manufacturing exports are shipped to the United States.

Canada's Economic Strengths

¶6. (U) Despite the challenges noted above, Flaherty - and the government's Statement in more detail - stated that Canada may be well positioned to weather the global economic storm. In particular, the Statement noted that:

--The Canadian housing sector is sound, with subprime mortgages accounting for less than 5 percent of new mortgages. Canadian lenders must also insure against default any mortgages with less than a 25 percent down payment;

--Canada's banks and other financial institutions are liquid and well capitalized, and have lower leverage ratios than their international peers; and

--Core Consumer Price Index (CPI) inflation has remained low, stable and predictable - and is within the Bank of Canada's targets.

Strengths of the Canadian Financial System

¶7. (U) The government's Statement also stressed the underlying strengths of the Canadian financial system:

--Canadian capital requirements for financial institutions are well above minimum international standards.

--At the start of the financial crisis, Canadian banks' capital buffers on risk-adjusted assets were 9.5 percent, while many global banks had capital ratios of only 6 or 7 percent.

--Canadian banks are also less leveraged than many of their international financial institution counterparts. Canadian banks' overall assets amounted to less than 20 times their capital, while major U.S. banks had 30 times more assets than capital and some European banks were leveraged up to 50 times.

--Large Canadian investment houses are owned by banks, and are regulated on a consolidated basis by the Office of the Superintendent of Financial Institutions.

No Stimulus Announced Yet - Other Measures in Meantime are Modest
----

¶8. (SBU) Flaherty also announced plans focused on the federal
Q8. (SBU) Flaherty also announced plans focused on the federal
government's internal economy such as a limiting wage increases to public servants, limiting federal workers' right to strike (although

in the political firestorm of the weekend, they have backtracked from that stance), cutting federal spending on travel, hospitality, conferences, exchanges and political services, and most controversially, eliminating federal subsidies to support political parties that receive more than 2 percent of the national vote (See ref a; again something the government appeared to retreat from in the wake of the political reaction).

¶9. (U) Minister Flaherty made it clear the government will likely wait until the actual budget (which, according to statements on the weekend from the Finance Minister will come, atypically, in late January 2009) before unveiling a possible fiscal stimulus package as recommended at the G20 Summit in Washington on November 14-15. Flaherty - and the government's Statement - said the Harper government's tax cuts since 2006 were in effect a pre-emptive stimulus package, with Canadian taxpayers paying C$31 billion less in taxes (almost 2 percent of GDP) in FY2009-10. The government's Statement also noted the importance of infrastructure spending in providing fiscal stimulus and said budget programs supporting provincial, territorial and municipal infrastructure projects are scheduled for a large increase to C$6 billion in 2009. The government also stated that it is looking to speed up the roll-out of anticipated infrastructure projects.

¶10. (SBU) Comment: The IMF has recommended that countries spend an average of 2 percent of GDP on fiscal stimulus actions. Senior Bank of Canada officials privately tell us that each country faces differing circumstances, and that monetary policy is still effective in Canada. As a result, the Canadian government may look to the Bank to use monetary policy in place of fiscal actions to stimulate the economy in the coming months. The Bank expects to make further stimulus rate cuts - on top of the 75 basis points in October 2008(and the 225 basis points since December 2007). Currently the Bank of Canada "key lending rate" to banks rate is 2.25 percent. The next Bank announcement on interest rates is scheduled for Tuesday, December 9. Bank officials also state that cutting consumption taxes - as, in part, the Harper government has done - is an inefficient fiscal stimulus that does little to change spending behavior. The officials say that more efficient spending - such as on infrastructure projects or direct transfers to individuals- has a greater domestic multiplier effect than cutting taxes.

¶11. (SBU) Comment: Given the structure of the Canadian economy (see para 5) Embassy would not be surprised if the government's relatively rosy projections do not face at least some downward

revision in coming months. End comment.

Wilkins